UNITED STATES BANKRUPTCY COURT

NORTHERN DISTRICT OF CALIFORNIA

In re: GIANNOTTA PROPERTIES, INC., Debtor(s).	Case No. 95-56961-JRG Chapter 11 **ORDER ON JOHN GIANNOTTA'S JURISDICTIONAL OBJECTION TO CONFIRMATION**

I. INTRODUCTION.

The debtor, Giannotta Properties Inc., is a California corporation that filed its chapter 11 petition on October 24, 1995. Only two directors, Carmella Giannotta and Pasquale Giannotta, attended the meeting at which the bankruptcy filing was purportedly authorized. The remaining director, John Giannotta, neither attended the meeting nor furnished written consent to either the meeting or the action taken at the meeting.

On October 23, 1996, as part of his objection to the confirmation of a plan of reorganization proposed by the debtor, John Giannotta raised the issue of the propriety of the debtor's filing for bankruptcy. The crux of John Giannotta's argument is that the filing of the bankruptcy petition was invalid because it was based on an invalid corporate resolution, and therefore,

this court lacks the jurisdiction to hear this case. He argues the resolution was invalid because the directors' meeting purporting to authorize the filing was held without a quorum being present. In response, the debtor argues it is excepted from the quorum requirements arising under California law.

Carmella Giannotta and Pasquale Giannotta have conducted two additional meetings after the debtor filed bankruptcy that are relevant to the objection before the court. The first was a shareholders' meeting held on May 31, 1996, at which they attempted to cancel the shares of stock held by John Giannotta and remove him as a director. The second was a board of directors meeting held on February 20, 1997, at which they attempted to appoint two new directors and thereafter ratify the bankruptcy filing. The debtor argues that the resolution appointing the two new directors is excepted from the normal quorum requirements for board meetings and, as a result, the bankruptcy filing was ratified by the approval of four directors on February 20, 1997.

For the reasons set forth below, the court finds that the filing of the bankruptcy petition by the debtor was neither duly authorized nor ratified under California law by the actions just described. However, the court also finds that the passage of time coupled with the circumstances of the case preclude John Giannotta from seeking dismissal on this ground.

II. DISCUSSION.

A. The Validity of the Original Resolution Authorizing the Filing is Determined under California Law.

It is undisputed that state law controls the requirements for a valid, voluntary bankruptcy filing by a corporation. Price v. Gurney, 324 U.S. 100, 106-107, 65 S.Ct. 513, 516-517, 89 L.Ed. 776 (1945); In Re American Globus Corp., 195 B.R. 263, 265 (Bankr.S.D. N.Y. 1996) (citing In re Autumn Press, Inc., 20 B.R. 60, 61 (Bankr.D.Mass. 1982)). The record before the court indicates that the debtor was organized under California law and primarily conducts its operations in California. It is clear that California law governs the validity of the debtor's bankruptcy filing.

The California Corporations Code establishes the procedural requirements for a valid action to be taken by a corporation.[1] The debtor argues that the corporate governance formalities required by California law have been relaxed as a result of the manner in which the corporation has operated throughout its existence. However, the debtor does not provide any authority under California law that supports this argument. Instead, the debtor cites cases that construe the law of other states. See, e.g., In re American Globus Corp., 195 B.R. at 265 (Bankr.S.D.N.Y. 1996) (interpreting New York corporate law).

In California, corporate governance formalities are relaxed only for close corporations.[2] When a corporation has close corporation status, Corporations Code § 300(b) excepts the

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[1] Unless otherwise stated all references to "Sections," "Code," or "Corporations Code" are references to the California Corporations Code.

[2] Statutory close corporations are created under § 158 of the California Corporations Code and are to be distinguished from closely held corporations. See, Statutory Close or Closely Held Corporation? Don Berger (1980) 11 Pacific L.J. 699.

corporation from certain corporate formalities. See, e.g., In re Annrhon, Inc., 17 Cal.App.4th 742, 755-756, 21 Cal.Rptr. 599 (1993) (explaining that a shareholders agreement can "dispense with the formalities of directors' and shareholders' meetings" in close corporations).[3] The debtor is not a statutory close corporation because the articles do not contain the language "[t]his corporation is a close corporation" as required by Corporations Code § 158(a). Although a non statutory close corporation is legally possible, notwithstanding the adoption of statutory close corporation legislation in California, there is no evidence of any agreement among the shareholders of the debtor creating a non statutory close corporation. See generally 3 Marsh, Cal. Corporation Law (3d ed. 1992 supp.) § 22.1, p. 1824. Based on these facts, the court concludes the debtor is not a close corporation under California law.

For corporations not having close corporation status, § 300(a) provides that "the business and affairs of the corporation shall be managed and all corporate powers shall be exercised by or under the direction of the [board of directors]." As a result, in order for debtor to take a valid corporate action, such as authorizing the filing of a bankruptcy

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[3] Cal.Jur. describes informal corporate operation as follows:

> While it is true that a corporation ordinarily acts by resolutions that are adopted at formal meetings of its board of directors and are entered in its minutes, it is also true that decisions reached by all the directors and shareholders of a **close corporation** at informal conferences will be binding upon the corporation when, by custom and with the **consent of all concerned**, corporate formalities have been dispensed with and the corporate affairs have been carried on through such informal conferences.

15 Cal.Jur.3d (Rev.) § 24 p. 89-90. (emphasis added); See, also the Legislative Committee Comment to § 158 of the Corporations Code.

petition, it must do so at a duly held meeting of its board of directors.

It is not inherently unfair to require family corporations to follow the governance requirements of California's corporate law. The shareholders of the debtor organized in corporate form, thereby utilizing the advantages of this form of doing business. As a result, they must be prepared to live with the laws that govern such arrangements. See, e.g., Ovadia v. Abdullah, 24 Cal.App.4th 1100, 1109-1111, 29 Cal.Rptr.2d 527 (1994) (holding that a family owned corporation was not excused from corporate formalities in voluntary dissolution proceedings "by virtue of their size or ownership."). Accordingly, Carmella Giannotta and Pasquale Giannotta are not free to disregard the legal rights of John Giannotta, who is both a fifty percent shareholder and a director, when making major decisions such as the filing of a bankruptcy petition.

B. The 1995 Resolution Purportedly Authorizing the Bankruptcy Filing was Invalid Because a Quorum was not Present at the Meeting.

Corporation Code § 307(a)(8) requires a quorum to be present at a directors' meeting in order to validly transact business. Section 307(a)(7) defines a quorum as: "A majority of the authorized number of directors. . . ." Consistent with this statutory provision, Section 13 of Article II of the debtor's own bylaws define a quorum as "[a] majority of the number of Directors as fixed by the Articles of Incorporation or

By-laws. . . ." The debtor has five authorized directors.[4] Therefore, three directors are required to constitute a quorum at any meeting of directors.

The debtor argues that a quorum should be a majority of the three long-standing directors, and thus only two directors should be needed for a quorum. Section 307(a)(7) clearly provides that a majority of the authorized directors is required in order to constitute a quorum. Assuming *arguendo* that the number of authorized directors could be validly reduced below five under California law, there is no evidence of an intent to do so in this case. Rather, the evidence from the board's minutes is to the contrary. The relevant minutes reveal that:

> [t]he chairman stated that nominations were open for directors and while the bylaws called for the election of five directors, corporations affair [sic] could presently be handled with three directors. It was further suggested that the other two directors would be filled when circumstances required.[5]

There is a contradiction between the plain meaning of this statement and the reduced quorum requirement suggested by the debtor. The proposition that the number of authorized directors was reduced is precluded by the statement allowing for the vacant director seats to be filled in the future, which

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[4] The number of directors and the procedures for changing the number thereof are provided for in Section 2, Article II of the debtor's bylaws. This section reads as follows: "The authorized number of directors of this corporation shall be five (5). This number may be changed by amendment to the Articles of Incorporation or by an amendment to this Section 2, Articles II, of these Bylaws, adopted by the vote or written assent of the shareholders entitled to exercise majority voting power."

[5] The minutes of the First Meeting of the Board of Directors held on May 9, 1978.

necessarily requires that authorized seats remain available for the future directors to fill. Therefore, the contention that only two directors are needed for a quorum must be rejected.

No quorum existed at the October 24, 1995 meeting because only two directors were present. No business could be validly transacted at that meeting, other than adjourning the meeting pursuant to § 307(a)(4). The purported action taken could have been validated if John Giannotta had furnished a written consent to the action pursuant to § 307(b). As he did not, the only possible conclusion is that the resolution purportedly authorizing the bankruptcy filing is invalid.

C. The Actions taken at the Shareholders' Meeting on May 31, 1996 are Invalid Because the Applicable Quorum Requirements were not Met.

John Giannotta has been both a director and a fifty percent shareholder of the debtor. Carmella Giannotta and Pasquale Giannotta attempted to remove John Giannotta from these positions at a purported shareholders' meeting that was held on May 31, 1996. However, Section 7 of Article I of the debtor's bylaws defines a quorum for a shareholders' meeting as a "majority of the shares entitled to vote." This provision is in accordance with the quorum requirements established in Corporations Code § 602. By virtue of John Giannotta's status as a fifty percent shareholder, no quorum could be formed at a shareholders' meeting without either his presence or proxy. Consequently, any resolution passed at such a meeting, other than to adjourn the meeting, is invalid under § 602. As a result, John Giannotta's status as a director and fifty percent

shareholder was not changed by the purported resolution of Carmella Giannotta and Pasquale Giannotta.

D. The Attempt to Fill Vacant Board Seats on February 20, 1997 was Invalid, and, as a Result, the Attempted Ratification of the Bankruptcy Filing by the Board of Directors Failed.

The debtor contends that the normal board quorum requirements did not apply to the meeting on February 20, 1997, at which the fourth and fifth directors were allegedly appointed. However, analysis of the relevant statutes and bylaws reveals that a normal quorum is required where there are enough directors remaining in office to potentially constitute a normal quorum.

Corporations Code § 305(a) provides:

> Unless otherwise provided in the articles or bylaws and except for a vacancy created by the removal of a director, vacancies on the board may be filled by approval of the board (Section 151) or, if the number of directors then in office is less than a quorum, by (1) the unanimous written consent of the directors then in office, (2) the affirmative vote of a majority of the directors then in office at a meeting held pursuant to notice or waivers of notice complying with Section 307 or (3) a sole remaining director. Unless the articles or a bylaw adopted by the shareholders provide that the board may fill vacancies occurring in the board by reason of the removal of directors, such vacancies may be filled only by approval of the shareholders (Section 153).

It is clear that when the number of directors in office can constitute a quorum, vacancies on the board may be filled by approval of the board. This approval must take place at a duly held meeting, which requires a normal quorum pursuant to § 307(a)(8).

Section 305(a) provides for an exception to the normal

quorum requirement "if the number of directors then in office is less than a quorum." That is not the case here because there were still three directors in office who could constitute a normal quorum.

Section 305(a) provides another exception where a different procedure is "otherwise provided in the articles and bylaws. . . ." However, in this case neither the debtor's articles nor its bylaws provide for an alternative to the general requirements of § 305(a). The pertinent provision of the bylaws is in Section 4 of Article II, which provides:

> "[v]acancies on the Board of Directors may be filled by a majority of the remaining directors, **though less than a quorum**, or by a sole remaining Director." (emphasis added).

This provision only addresses the voting procedures for appointing directors. Importantly, it is silent as to what occurs where the number of remaining directors in office can constitute a quorum.

No relevant California case interpreting a "though less than a quorum" provision in bylaws has been found. The court notes that in Tomlinson v. Loew's Inc., 135 A.2d 136 (Del. 1957), aff'g, 134 A.2d 518 (Del. Ch. 1957), the Delaware Supreme Court analyzed a similar provision in a corporation's bylaws and found that the normal quorum requirement was still in effect where there were enough directors in office to potentially constitute such a quorum. The Tomlinson provision, which involved language similar to Section 4 of Article II of the debtor's bylaws, is as follows:

> If the office of any member of a committee or of the President, a Vice-President, the Secretary, Treasurer or any other office or agent becomes vacant, the directors in office, **although less than a quorum**, may appoint any qualified person to fill such vacancy, who shall hold office for the unexpired term and until his successor shall be duly chosen. A vacancy in the Board of Directors may be filled by the stockholder or by the directors in office (although less than a quorum). Article V, § 2 (emphasis added).

134 A.2d at 523.

The Tomlinson Court noted that the corporation's general bylaw provisions, which required a quorum, would allow a vacancy to be filled without need to resort to Article V, § 2, because sufficient directors were available to constitute a quorum. Id. at 524. It is only in the absence of any possible quorum that the provision allowing a vacancy to be filled without a quorum is applicable.

Similarly, the debtor's bylaws did not provide for a waiver of the quorum requirements where enough directors were in office to constitute a quorum. This conclusion is reinforced by the definition of quorum in Section 13 of Article II of the bylaws:

> "A majority of the number of Directors as fixed by the articles of incorporation or By-laws **shall** be necessary to constitute a quorum for the transaction of business . . . . (emphasis added).

In light of the Section 13's expansive definition as to when a quorum is required, Section 4 of Article II, which provides that "vacancies in the Board of Directors may be filled by a majority of the remaining directors, though less than a quorum . . . ," should be narrowly interpreted to allow for director appointments when a quorum cannot be formed due to insufficient directors in office.

Because the debtor's board of directors' meeting on February 20, 1997 did not meet applicable quorum requirements, the fourth and fifth directors were not validly appointed. Therefore, the attempted ratification of the bankruptcy filing fails due to the absence of John Giannotta, the director whose presence was needed to constitute a quorum at that meeting.

Importantly, this court's ruling on the appointment of directors does not result in the corporation remaining in permanent deadlock. Other mechanisms are provided by the California Legislature to resolve corporate governance issues. See generally 3 Marsh, Cal. Corporation Law (3d ed., 1992 supp.) § 22.20, p. 1876-1877. This point was further underscored in Anmaco, Inc. v. Bohlken, 13 Cal.App.4th 891, 16 Cal.Rptr.2d 675 (1993), which involved allegations of gross misconduct. In Anmaco, one fifty percent shareholder, while acting as the corporation's president, caused the corporation to bring legal proceedings against the other 50 percent shareholder, who was alleged to have committed various wrongful acts against the corporation, including fraud on the corporation. Id. at 895-896. The court upheld a motion for summary judgment dismissing the legal proceedings as unauthorized corporate acts. In doing so, the court explained that:

> The usual remedies available in the case of deadlock in a small corporation include: appointment of a provisional director (Corp.Code, § 308); removal of a dishonest of fraudulent director (Corp.Code, § 304); appointment of a receiver, in limited situations (Code Civ.Proc., § 564, subd. (b)(5); and involuntary dissolution of the corporation (Corp.Code, § 1800). . . .

Anmaco, Inc. v. Bohlken, 13 Cal.App.4th 891, 900 n.3, 16

Cal.Rptr.
2d 675 (1993).

E. The Passage of Time Coupled with the Circumstances of the Case Preclude John Giannotta from Seeking Dismissal on this Ground.

Having found that the debtor's bankruptcy filing was neither duly authorized nor ratified by the debtor's board of directors, the court now examines the conduct of the moving party, John Giannotta. John Giannotta waited approximately one year to complain about the validity of the debtor's bankruptcy filing. Additionally, he brought this action as an objection to confirmation of a plan of reorganization. This plan, if confirmed, would have resulted in the transfer of real estate from the debtor, of which he is a fifty percent shareholder, to another entity in which he has no current ownership interest. This circumstance leads the court to conclude that John Giannotta took a "wait and see" approach to the debtor's bankruptcy proceedings. When he did not like the potential outcome of these proceedings, he attempted to "bail out" of these proceedings by objecting to the debtor's plan of reorganization on the theory that the year-old bankruptcy filing was invalid. When this court compares the conduct of John Giannotta with the conduct of the parties in the cases noted below, his conduct clearly falls in the pattern of time and circumstance that warrants rejecting his challenge to the propriety of the debtor's bankruptcy filing.

Other Courts have consistently rejected tardy objections to corporate bankruptcy filings involving similar combinations of

time and fact. In the course of rejecting these challenges, courts have uniformly concluded that a defect in the initial corporate bankruptcy filing was not necessarily fatal to the proceedings. For example, the Fourth Circuit Court of Appeals has held that a fifty percent shareholder had ratified an initially invalid corporate bankruptcy filing because he waited over a year to challenge the filing. Moreover, the movant filed his objection after the trustee dunned him for funds that allegedly belonged to the corporation. Hager v. Gibson, 108 F.3d 35, 38-40 (4th Cir. 1997). The Fifth Circuit Court of Appeals also ruled against the objections of a fifty percent shareholder, who had waited over a year to claim an invalid corporate bankruptcy filing, on the grounds that she had acquiesced the filing. In that case, the movant challenged the bankruptcy filing to improve her chances of collecting $100,000 of life insurance proceeds that were payable to the debtor. Matter of Atlas Supply Corp., 857 F.2d 1061, 1062-64 (5th Cir. 1988). Another Court has held that even a 100% share- holder, who had "participated significantly in the proceedings," could not vacillate for over three years and successfully challenge the validity of the bankruptcy filing of his own corporation. In re Martin-Trigona, 760 F.2d 1334, 1341 (2nd Cir. 1985). See also, In re Farrell Realty Co., 10 F.2d 612, 614-615 (W.D. Pa. 1925) (holding, in part, that directors and stockholders, who were cognizant of the bankruptcy filing, could not be permitted to put an end to bankruptcy proceedings after standing "by for six months without action, and allow[ing] the rights of innocent

persons to be affected . . . ."); In re American Globus, 195 B.R. 263, 265-266 (Bankr.S.D.N.Y. 1996) (finding, in part, that dismissal of the debtor's bankruptcy petition inappropriate where the president of movant corporation was the alleged recipient of transfers from the debtor corporation that might be avoidable by the Chapter 7 trustee); I.D. Craig Service Corp., 118 B.R. 335, 337-338 (Bankr.W.D.Pa. 1990) (holding that board of directors of a corporate debtor could not challenge its bankruptcy filing because the directors had waited over a year to object and engaged in participatory conduct in the bankruptcy proceedings). Significantly, these courts arrived at similar results using several different legal theories. See, e.g., Hager v. Gibson, 108 F.3d 35, 38-41 (4th Cir. 1997) (ratification under state law supplied the necessary subject matter jurisdiction); Matter of Atlas Supply Corp., 857 F.2d 1061, 1062-64 (5th Cir. 1988) (acquiescence under In re Farmer's Supply Co., 275 F. 824 (5th Cir.1921)); In re Martin-Trigona, 760 F.2d 1334, 1341 (2nd Cir. 1985) (acquiescence to the proceedings); In re Farrell Realty Co., 10 F.2d 612, 614-615 (W.D.Pa. 1925) (to dismiss the bankruptcy after a year has elapsed would be inequitable and unjustifiable); In re American Globus, 195 B.R. 263, 265-266 (Bankr.S.D.N.Y. 1996) (under New York law nonuse of a bylaw "may work its abrogation." (citation omitted)); and I.D. Craig Service Corp., 118 B.R. 335, 337-338 (Bankr.W.D.Pa. 1990) (ratification and laches).

Now, this court, like the courts that have previously considered this issue, must also reject John Giannotta's "wait

and see" approach.

III. CONCLUSION.

Based on the foregoing, the jurisdictional objection of John Giannotta is overruled.

DATED: _____

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JAMES R. GRUBE
UNITED STATES BANKRUPTCY JUDGE